

MEMORANDUM

35226

NATIONAL SECURITY COUNCIL

INFORMATION

SECRET

DOS Review Completed.

December 6, 1971

MEMORANDUM FOR: HENRY A. KISSINGER

FROM: ROBERT THORMATS RH

ON-FILE NSC RELEASE
INSTRUCTIONS APPLYSUBJECT: CIA Report on Foreign Reaction to International
Aspects of the New Economic Policy

CIA Director Helms has sent you a personal copy of a memorandum (Tab A) evaluating foreign reaction to the international aspects of the New Economic Policy, including the economic and political impact abroad, and the likely responses of foreign nations. I have attempted a brief summary for you and a shorter summary (at Tab I) for the President.

The New Economic Policy came "as a shock" to the International Community. There was apprehension that the surcharge would have immediate disruptive effects on foreign economies, that the job development tax credit would severely restrict the import of foreign equipment, and that the Domestic International Sale Corporation (DISC) would illegally subsidize American exports. The initial reactions were tempered by the hope of a quick settlement of the underlying issues, but the possibility of a prolonged impasse has given rise to growing concern about the future. Foreigners fear the combined effects of instability in foreign exchange markets, the possibility of competitive trade restrictions, and a U.S. retreat into protectionism and isolationism.

Economic Effect

The economic impact of the NEP on foreign countries has so far been small, but there is danger that it will become considerably larger in coming months if the impasse continues. There is concern that by trying to do too much too quickly, the U.S. may risk triggering a worldwide recession.

The NEP caught most industrialized nations at a sensitive moment: an economic slowdown was already underway in Germany; in Italy strikes, large wage increases, and political uncertainty had nearly halted economic expansion; in Japan a slowed-down economy was just beginning to improve; in Britain recent expansionary policies to produce an up-turn in a stagnating economy had not yet brought about the expected upturn; and Canada, although recovering from a recession, still had a higher unemployment rate (7.1%) than the U.S., chiefly because of its rapidly growing labor force.

SECRET

~~SECRET~~

2

The NEP, coming at this time, had a major psychological impact and contributed further to an emerging crisis of economic confidence. Uncertainty in exchange rates makes investment decisions more difficult and causes consistent apprehension about the future of international trade. Germany and Japan, whose currencies have appreciated significantly, and whose exports are diminished by the general economic uncertainty, are extremely concerned about their export prospects. Germany seems to be developing a "recession mentality". Investment throughout the industrialized world is off -- and estimates of GNP growth are being revised downward.

The economic impact of our policy varies from country to country. Canada's manufacturing development has been seriously hurt by the surcharge and the Canadian dollar's float in the past year. Lacking substantial foreign markets outside of the U.S. for much of its manufacturing exports, and some of its raw materials, Canada is hard pressed to reach some agreement with the U.S. In Japan small and middle-sized enterprises which turn out "sundry goods" will suffer, but important export industries are sufficiently competitive to absorb the impact of the surcharge. In Western Europe potential economic damage is relatively small. Some growth in industry will be affected -- perhaps more by the proposed investment tax credit than by the surcharge. But few Western European countries send as much as 10% of their exports to the U.S. and most send much less. All could prosper if they kept up a brisk level in their far more important trade with each other.

Political Effect

The NEP has created -- or added to -- domestic political problems for some of our allies. Sato may be forced to leave office sooner than he would have liked. In Germany, Canada, Italy and U.K. trade is a prime political issue and our share of the blame for their economic troubles will be greater than our contribution to them. The spectre of U.S. protectionism will help Britain, Norway and Denmark "sell" entry into the EC to their electorates, and harden the determination of the EFTA neutrals to make industrial free trade agreements with the enlarged EC. France, which has less political desire or economic incentive than most West Europeans to resolve present economic problems, has stressed a more "European solution" to the problem which stresses European unity vis-a-vis the U.S. And the domestic heat is on the West German Government to disprove the charge that its eagerness to help the U.S. has led to a weakening of West European and especially Franco-German ties.

Probable Responses

The NEP already has produced general agreement on the need for worldwide currency realignments. Japan, Germany and Canada expect to make some upward adjustments from their old parities. But there is no indication that

SECRET

3

foreign governments will do much more unilaterally than they already have.

Many governments believe that if the surcharge is not lifted by early 1972 it will stay on through the U. S. elections. They fear that by that time relations with Washington will have worsened -- and maybe the political fortunes of some of our friends as well.

EC, Gold and the Dollar -- Pressure is growing in the EC for a restoration of normal conditions for intra-EC trade and for a resumption of progress toward economic unity and monetary union. Member countries prefer a currency alignment on a global basis, which would include a devaluation of the dollar in terms of gold. France has stated that it will not revalue the franc, Germany will not revalue to a point significantly higher than the franc since its industry -- which is now moving slowly -- would be at a significant competitive disadvantage vis-a-vis French industry. Britain faces the same problem. Thus a change in the value of the dollar is considered necessary by the Europeans if the magnitude of exchange rate realignment we desire with the EC is to be realized. But if no settlement is reached soon, the EC countries are likely to establish fixed parities among themselves. The main obstacle to such a step has been that Germany favors a joint float vis-a-vis the dollar, while France insists on fixed rates based on the present gold parity of the franc. The French are in a stronger bargaining position -- their economy is in good shape and they can afford to wait. Germany -- whose currency has appreciated more than others in Europe and who is threatened by a recession -- cannot let the present situation continue for long. A compromise on terms closer to those of France is likely. Because most trade of the EC is among the member countries, agreement on new parities within the EC would reduce economic pressures for an accommodation with the U. S.

To facilitate a global settlement Germany and Japan would be willing to make some concessions. However, the Western Europeans are unlikely to agree to unilateral trade concessions. They will neither change the essentially protectionist Common Agricultural Policy nor hold off in their efforts to bring the "EFTA non-applicants" into an industrial free trade arrangement with the EC. Developments since August 15 may, in fact, have created a sense of need to strengthen European institutions as a bulwark against a menacing outside world. And Japan, although probably amenable to some additional sharing of defense burdens, would balk at any measures -- such as

SECRET

SECRET

4

assuming a greater share of the cost of U.S. forces in Japan -- which would entail renegotiation of the basic U.S. -Japanese security agreements.

Some of the understanding and sympathy which the U.S. problem was accorded last August is beginning to erode, and this is likely to continue unless at least the outlines of a settlement are worked out at a fairly early date.

RECOMMENDATION:

1. That you sign the memorandum for the President (Tab I) summarizing the CIA memorandum.
2. That you sign the note (Tab II) thanking Dick Helms for sending this to you.

Mr. Peterson concurs.

SECRET